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FIRST NATIONAL CITY BANK
Monthly Letter
Business and Economic Conditions

General Business Conditions

New York, October 1961

THE improvement in business, according to data presently available, seems to have slowed down, temporarily, in September. The automobile strikes, hitting General Motors for two weeks, and threatening other producers as we go to press, have affected not only this important industry but also its suppliers. Meanwhile, unseasonable weather, and two hurricanes, slowed trade in a number of areas. Nevertheless, political and business leaders hold to the sanguine view that the momentum of business expansion is firmly established and will maintain its force well into, if not throughout, 1962.

There has been no arrest in the quarterly rise of gross national product, officially estimated to have increased to a seasonally adjusted annual rate of $526 billion in the third quarter from $516 billion in the second quarter and $501 billion in the first. Treasury Secretary Douglas Dillon is forecasting the fourth quarter GNP at a level of $540 billion which, if realized, would create a $521 billion figure for 1961 as a whole, up 3.2 per cent from 1960. The chairman of the President's Council of Economic Advisers, Dr. Walter W. Heller, has raised his sights for 1962, suggesting that the GNP may attain a $560 billion-a-year rate in the first half of next year and conceivably could reach $600 billion as early as the end of 1962.

In view of these ebullient estimates, the unemployment problem does not appear as intractable as it did last spring when a more gradual rate of recovery was anticipated. Despite record levels of nonfarm employment, the seasonally adjusted rate of unemployment persisted during the summer at just under 7 per cent of the labor force. However, Secretary Dillon anticipates that "unemployment should fall to 6 per cent or less by Christmas and possibly to 5 per cent by the middle of 1962. A year from now, if all goes well, unemployment should be gradually approaching 4½ per cent on its way to the 4 per cent level presently considered to be reasonably full employment."

The Federal Reserve index of industrial production (1957=100), up only 1 point in August to 113, was held back in September principally by the auto strikes. Shortages of cars in turn depressed retail sales volume. Steel mill operations during August and September increased about in line with usual seasonal expectations—a good showing considering the uncertainties in the auto situation.

Optimism for the fourth and succeeding quarters is based on the rising trend of new orders in manufacturing, helped by defense procurement, as well as on the increase in buying power released by a record flow of personal incomes. Business spending on new plant and equipment is now moving upward, although in a restrained way. It will take a stronger recovery in profits than so far has been experienced to set in motion a more decisive expansion of investment outlays.

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Auto Wage Settlement

With settlement of disputes on wages, fringes, and local working conditions, automobile manufacturers will be straining to accelerate production and get the new models into dealer showrooms and into the hands of waiting buyers. September output totaled less than 350,000 cars compared with 505,000 originally scheduled. Only prolongation of labor disputes will prevent the industry from exceeding 600,000 in October.

The GM-UAW settlement called for annual wage increases, amounting to 21.7 cents an hour over a three-year period, plus a wide variety of fringe benefits. The company reluctantly extended unlimited cost-of-living allowances, liberalized supplemental unemployment benefits (SUB), and introduced a new scheme to compensate workers for time lost in short workweeks. No precise dollars-and-cents figure can be calculated for the over-all size of the "package." But the best guess seems to be that, over the three-year life of the contract, the cost of an hour's labor will rise somewhere around 4 per cent a year.

The Price of Steel

Enlargement of government spending, superimposed upon enlargement of private spending, is raising flows of income to new peaks and also, not unnaturally, arousing apprehensions of a renewed bout of inflation. That prices, in the circumstances, should show tendencies to firm should surprise no one. In the agricultural sector—as witness the increase of more than $1 billion in support levels for farm products this year—it is the deliberate policy of government to raise prices. Again—as witness the $500 million price tag on the recently enacted increase in the federal minimum wage—it is government policy to raise the costs which employers, if they are to stay in business, must cover in higher prices. The generous wage contract obtained by the auto workers will set a standard which other unions will want to reach if not exceed.

Moreover, the rosy hope that business expansion will swell the federal revenues to a record level of $90 billion or more, and rebalance the budget, would seem to imply a generally rising drift of prices. There is no other way that industry can develop sufficient levels of profits and tax liabilities. Indeed, it is possible to predict that, unless the downtrend of business profit margins is decisively reversed, we will fail both to rebalance the budget and to absorb the slack of unemployed resources. The financial means, and incentive, will be lacking for realizing our full productive power.

With stability of employment costs, we could look forward to expansion in employment and production without general advance in industrial prices. But labor contracts which add 4 per cent a year or thereabouts to employment costs are not consistent with expansion of employment *and* over-all price stability. The average annual gain in labor productivity, historically, is more like 2 per cent than 4 per cent.

There is some widening appreciation, as noted in the article on "The Problem of Rising Prices" in the September issue of this *Letter*, that the greatest threat to the dollar comes from "wage-price cost-push inflation." President John F. Kennedy showed an awareness of the problem when he asked the United Auto Workers and the leading automobile companies, during the course of wage negotiations, for a "noninflationary" settlement. "Noninflationary" in this context is commonly defined as not involving price increase. The auto companies may be able, without sacrifice of quality, to find economies to keep car prices on a fairly even plane. Many other employers, faced with equal wage demands, will not be so fortunate.

Steel has figured more prominently than motor cars in recent discussions of price. The steel industry is operating under the 30-month wage contract signed in January 1960. At the expense of a 116-day strike, suspended by invocation of the Taft-Hartley Act procedures for a cooling-off period, the contract reduced the annual rate of rise in steel employment costs from 8 per cent a year, prevailing from 1940 to 1959, to an estimated 3½ to 3¾ per cent a year.

The Senate Debate

Even the moderated rise in steel employment costs, as industry leaders warned at the time, involved upward pressures on the price of the metal. The ink on the contract was scarcely dry before guessing began as to when the price might be advanced. During the business recession, prices of a number of steel products were actually marked down in recognition of competitive pressures. But, during the summer, talk arose of price adjustments after October 1 when steel workers were scheduled to get the final installment of pay increases provided under the January 1960 settlement. Expectations of a price advance led to a major debate on the floor of the Senate. On August 22, a group of Senators, largely ignoring the pattern-setting auto wage negotiations then under way, took turns in a series of speeches to warn the steel industry against any increase in prices. Senator Albert

Gore said it was "all too clear" that the steel companies would push up prices by about $5 a ton after October 1 "unless something is done to restrain such action":

> Should the U.S. Government choose to sit idly by in the face of this clear and present danger, we may find ourselves, by the early months of next year, caught up once more in the stifling coils of yet another inflationary spiral.

Stressing the importance of the metal, and the "psychological effect" of steel prices on other prices, he painted a picture of steel as a principal villain in the price inflation experienced over the period 1947-58. He alluded to "competent studies" showing that "40 per cent of the rise in the wholesale price index" over this period "was due to the fact that steel prices were pushed up faster and farther than the average of all other commodity prices." He cited an estimate furnished him by the President's Council of Economic Advisers that, with the scheduled wage increase but without price increase, steel industry profits during the fourth quarter of 1961 "will likely be equal to the average of the last 14 years, which is 10.5 per cent after taxes." This figure, it is worth mentioning, is below the 14-year average realized by U.S. manufacturing industry as a whole.

Senator Gore did not fail to take note of the cost-push process. At one point in his speech he went so far as to assert that "there are very real grounds for considering cost-push inflation the villain of the postwar price drama." Nevertheless, while stating that "the public and government must not stand idly by and be victimized by either big business or big labor, or both," the strong medicine he suggested for dealing with the situation was prescribed solely for employers. He suggested that the Federal Trade Commission "could move to police the steel industry," that the antitrust division of the Department of Justice "can get busy" and perhaps break up the large steel companies into smaller units, and that:

> Lastly, if all else fails, steel prices can be brought under utility-type regulations.

This is a staggering conclusion. It presumes, contrary to fact, that steel-making is a monopoly and that profits have been the main beneficiary of price advances. It overlooks the responsibility of government for the cost-push in steel. Maybe government would have more intestinal fortitude than the industry to stand against exorbitant demands from organized labor. But the record is not encouraging in this respect.

Senator Paul Douglas centered his fire on the United States Steel Corporation and offered charts suggesting that, with its improvement in efficiency, the corporation could break even with operations as low as 28 or 30 per cent of capacity. Senator Joseph Clark expressed concern over the decline of employment in the steel industry and predicted that "thousands upon thousands" will never get their jobs back. While he explained this as largely due to the progress of automation, he was highly critical of the doubling of the price of the metal since 1947 and entered into the record price indexes for a variety of steel products for the period 1947-61. He offered the generalization that steel prices have gone up as production rates have fallen off, "pretty clear evidence that the traditional law of demand and supply is not operating in the steel industry." Senator Mike Monroney spoke of the steel industry as resembling a "cartel system" of administered prices outside the range of competition.

Defense of the Industry

The steel industry was not without defenders. Other sides of the story were brought out in Senate debate on September 7. Senator Everett Dirksen called the attack an attempt at "psychological price control" and pointed out that "if threats can be used upon one industry they can be used upon another":

> If successful in the first instance or in the second instance, who shall say that the same weapon, fear, will not be employed on other occasions?

Senator Wallace Bennett expressed wholehearted agreement with a *New York Times* editorial "Price Fixing in Congress" which said in part:

> If the price of steel is to be determined by speeches and threats on the Senate floor, then a precedent has been set whose final consequence could be a great change in our economic system. The private-enterprise system operates on the assumption that prices should be set in the market place, and reflect the force of competition among buyers and sellers. The Senate floor is not the market place.

Senator Prescott Bush said "this is not a time to harass business." Senator Homer Capehart commented that, while we hear it said that measures must be taken to stop communism, "we turn around in many instances and adopt socialistic or communistic methods toward business."

The attack on steel was not without logical inconsistencies. For example, Senator Clark's tables showed reductions in prices of some steel items during the recent business recession, which contradicted his statement that prices have gone up as production has fallen off and showed instead that competitive forces were at work. After all, there are 241 U.S. companies listed in the American Iron and Steel Institute's *Directory of Iron and Steel Works*. Besides, there are in-

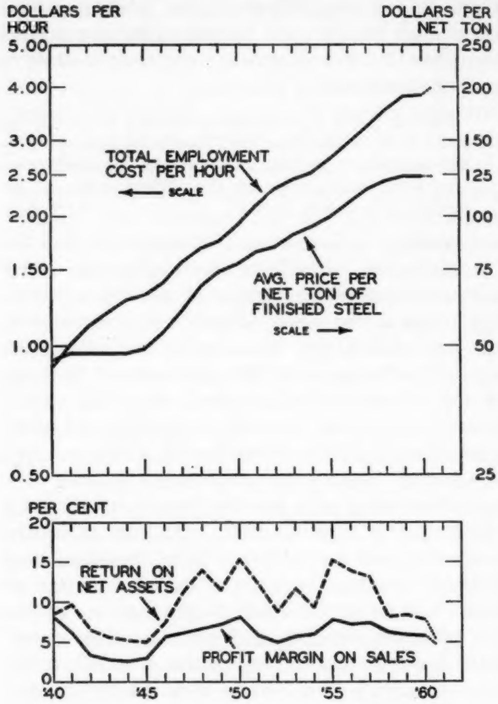
numerable foreign producers who, with much lower wage and tax costs, have become active participants in the market for steel in the United States.

Although reproving the industry for failing to heed the law of supply and demand, the critics in reality were asking steel producers to ignore it: in other words, to keep prices unchanged even though both elements in the law—strengthened demand and higher costs of supply—pointed to the propriety of at least selective upward adjustments.

Actually, the pricing policies of the industry have been based primarily on the cost or supply side of the supply-demand equation. Quotations have not been adjusted up and down sensitively to fluctuations in demand. The companies have followed a general practice of marking up prices in line with step-ups under wage contracts. During World War II, even though costs were rising, steel prices were arbitrarily pinned down by price controls; thus, part of the rise in price from 1945 to 1949 represented an effort of the industry to restore normal profit margins. But any impartial review of the behavior of steel prices since 1940 must inevitably come to the conclusion that it was the exceptional rise in costs which explained the exceptional rise in price. The accompanying chart shows the record, since 1940, of hourly employment costs as computed by the American Iron and Steel Institute and the average price of finished steel as figured by *Iron Age* magazine. In the bottom panel, profits are shown expressed as rates of return on net assets and on sales.

Senator Gore spoke of "competent studies" demonstrating that the rise in the price of steel explains 40 per cent of the rise in the wholesale price index, 1947-58. This bizarre statistic puts the blame on the steel industry for postwar inflation which had more fundamental causes: the tremendous buildup of spending power during World War II, the maintenance of an inflationary cheap money policy in the first six postwar years, pressures exerted by the government on the steel industry to raise wages, and higher levels of taxes and plant replacement costs. While frowning on increases in steel prices, government aided and abetted the wage increases which made them necessary if the financial strength and capital-raising power of a basic industry were to be sustained.

The study the Senator cited is one on "Steel and the Postwar Inflation" prepared by Otto Eckstein and Gary Fromm of Harvard. Anyone who wants to take the trouble to read the fine print in the report will find that the 40 per cent



Steel Prices, Employment Costs, Profit Margins, and Return on Net Assets, 1940-61

Sources: Steel prices, *Iron Age;* employment costs, American Iron and Steel Institute; profit margins and return on net assets, First National City Bank. 1961 figures are for first half.

figure is based on a complicated mathematical technique involving what the authors describe as "suppositions" and elements of "double counting." Moreover, descriptively though not statistically, the Eckstein-Fromm report did examine the record of government influence on steel wage settlements and said: "There can be little doubt that the effect of government has been to increase the rate of increase of wages."

Steel offers the classic example of cost-push inflation. And no industry put up a stronger resistance, as witness the series of long strikes that the companies took in efforts to put brakes on the process. In 1952, indeed, President Truman attempted to take control of the industry when it balked at accepting a generous wage settlement advocated by a misnomered Wage Stabilization Board. The responsibility of government, dramatized by these events, was ignored by Congressional critics.

The characteristic posture of government in any big and important strike is to get the thing settled and on terms the union will accept. The patient, hands-off attitude President Eisenhower assumed during the record-long 1959 steel strike

did assist the industry to achieve a slackening in wage-push inflation in steel and the relative stabilization of steel prices we have enjoyed the last three years.

President Kennedy's Letter

On September 7, President Kennedy made public a letter he had written to the heads of 12 steel companies. His letter picked up many of the points made in the Senate discussion though he did not endorse any of the more radical "solutions" proposed by Senator Gore. Stating that the steel industry "can look forward to good profits without an increase in prices," he attributed stability in the wholesale price index since 1958 to stability in steel prices:

> Steel is a bellwether, as well as a major element in industrial costs. A rise in steel prices would force price increases in many industries and invite price increases in others. The consequences of such a development might be so grave—particularly on our balance of payments position—as to require the adoption of restrictive monetary and fiscal measures which would retard recovery, hold unemployment at intolerable levels, and hamper growth.

The President said that the industry, by absorbing increases in employment costs since 1958, has demonstrated a will to halt the wage-price spiral in steel:

> If the industry were now to forego a price increase, it would enter collective bargaining negotiations next spring with a record of three and a half years of price stability. It would clearly then be the turn of the labor representatives to limit wage demands to a level consistent with continued price stability.

David J. McDonald, president of the United Steelworkers, later pledged cooperation of the union in next year's contract. He said that it had always been the policy of the union to consider the public interest.

That the President's letter stirred a sense of injustice among steel company executives was apparent from their replies. It seemed to some that the steel industry was being singled out for sacrifices in the "national interest" and was being asked to give up freedom (to adjust prices to cost conditions) in the name of preserving a free society.

In his reply, Chairman Roger M. Blough of U.S. Steel expressed unqualified agreement with the concern the President expressed over the inflationary trend of the past. While stating that U.S. Steel could not predict the future trend of prices in any segment of the industry, and had no definite conclusion regarding its own course, he took occasion to put the matter "in proper cause-and-effect perspective." He asserted that the cause of inflation in the United States—past, present, or future—would not be found in the levels of steel prices or steel profits. Mr. Blough quoted an official government report, prepared last year by Professor E. R. Livernash of Harvard for the Department of Labor, which concluded that, "while price policy can be debated in the short run, in the long run all cost increases must be met. Steel has done no more than this."

In the Senate debate, Senator Barry Goldwater went to the crux of the argument:

> If the steel industry, because of administered prices brought on by monopolistic power, was able to charge whatever it wanted, its exorbitant prices should be reflected in . . . rate of profits on sales and rate of return on investment.

These figures, as the Senator noted and as the chart brings out, show a weakening tendency of profits in the steel business. Thus, the Senator concluded, if the industry had the alleged monopolistic power, and ended up with this kind of result, "it is the most public spirited private enterprise in the history of this country."

As Senator Jacob Javits emphasized:

> . . . the vast capital invested in the steel industry comes directly or indirectly from the savings of our people, workers included, who were willing to put these savings at risk in the hope of a profit, and it is only profitable operation that can pay adequate wages and give proper conditions to men at work.
>
> * * *
>
> Economics by fiat would destroy the basic concept of economic freedom on which this Nation was founded —a concept that, because of its success, has become the hope of the entire free world.

Steel and National Defense

Senator Gore stated in his speech that "a stable price structure is essential to our strength and progress." President Kennedy quoted an estimate given by Secretary of Defense Robert McNamara that a steel price increase of the order of $4 to $5 a ton, once its effects fanned out through the economy, "would probably raise military procurement costs by $500 million per year or more." This figure would seem to suggest that, contrary to fact, most of the nation's steel is consumed in guns and tanks and warships. Finished steel production is running around 70 million tons a year and the great bulk is used by the automobile, construction, and miscellaneous manufacturing industries.

Apart from the manifest exaggeration of the estimate, there are worse things that could happen to this country than an increase in the price of steel.

One of these is the destruction of the freedoms of the market place and the substitution of political price-fixing, beginning with steel and spreading perhaps throughout industry. If nothing else, our wartime experience with price-setting bureaucracies, black markets, and deteri-

orations of quality should warn us against this course.

Something else that would be worse than an increase in steel prices would be an erosion of the industry's financial strength and capacity to raise capital and fulfill its essential role in the process of national growth. Steel is the sinew of war. Nothing would be more foolhardy from the standpoint of national defense than breaking up the industry into smaller and less efficient units, letting weaker companies perish, and dismembering our arsenal of democracy.

The buyer of steel must pay its cost of production. The nation's taxpayers cannot afford to have the steel industry become forced, as have the over-regulated railways, to go to Washington as supplicants for subsidies.

What responsible officials in Washington need most to remember is that a healthy steel industry is more important than some absolute of stability in steel prices; that broad price stability in a free society must be obtained by sound fiscal, credit, and wage policies and never should preclude individual adjustments in response to forces of supply and demand; that the steel business is a competitive business as evidenced by the difficulties the companies have been facing in maintaining the flows of essential profits; and that saving the dollar from continuing erosion specifically requires a greater sense of moderation among trade union leaders in asserting their demands as well as stronger measures of resistance among employers in meeting those demands.

Stimulating the Capital Market

This year, the word "nudging" was added to the lexicon of the capital market as the government sought to influence the cost and availability of long-term funds. These efforts have been praised as a needed stimulant to economic activity and growth, and also criticized as ill-conceived and disruptive of the smooth functioning of the market. The emphasis given to these actions testifies to the crucial importance of the capital market, where the supply of national savings is mobilized to finance the capital investment that builds national income and wealth.

Attempts to "nudge" the capital market have taken two main forms: reducing interest rates on bonds and mortgages, and directly supplying long-term loan funds through federal agencies. The first aim was set forth by President Kennedy in his Economic Message of February 2:

> Both full recovery and economic growth require expansion of expenditures for business plant and equipment, for state and local governmental facilities, and for residential construction. To increase the flow of credit for these purposes, long-term interest rates should decline. . . . Monetary policy and debt management must serve two apparently contradictory objectives: checking declines in the short-term rates that directly affect the balance of payments, and increasing the flow of credit into the capital markets at declining long-term rates of interest to promote domestic recovery. . . . A reduction of mortgage interest rates is already overdue.

The most controversial means of implementing this policy has been through the "nudging" operations of the Federal Reserve System which, beginning last October, laid aside its long-standing policy of confining open market operations to short-term Treasury securities and in mid-February began actively to purchase Treasury bonds and notes in the intermediate- and longer-term maturity ranges. These purchases were offset by sales of short-dated Treasury issues to prevent the development of excessive liquidity among the banks and to keep bill yields from collapsing and inviting foreign holders to pull their money out. The net impact on bank reserve positions has been to keep them easy at a free reserve level fluctuating around a $500 million average.

As the term implies, "nudging" by the authorities has not meant the establishment of fixed prices and yields for Treasury securities, but rather the exertion of pressures in the direction of higher bond prices and lower yields. In practice, the new policy has meant that there has been a better market for institutions selling off government securities in order to channel more funds toward loans, mortgages, and corporate and municipal bonds. Thus, since mid-February, Federal Reserve holdings of 1- to 5-year Treasuries have risen $2.6 billion, 5- to 10-year issues are up $1.1 billion, while Treasuries with maturities of 10 years and beyond have been purchased intermittently. (Investment accounts controlled by the Treasury, such as the old-age and survivors insurance trust fund and the unemployment trust fund, have focused their buying power mostly on the longer-term market.)

A second approach to lowering the cost of borrowing has been aimed directly at the mortgage market. On February 2, the maximum interest rate on home mortgages insured by the Federal Housing Administration (FHA) was cut from 5¾ to 5½ per cent, and on May 29 was reduced by another ¼ to 5¼ per cent. In addition, the Administration eased other terms of home financing. Under the Housing Act of 1961, signed by the President on June 30, minimum down payments on FHA loans were lowered and monthly payments were eased by stretching out the maximum repayment period from 30 to 35 years—and even up to 40 years for low-income

families seeking mortgages up to $15,000. In August, the Home Loan Bank Board eased the terms at which federal savings and loan associations may lend on conventional mortgages.

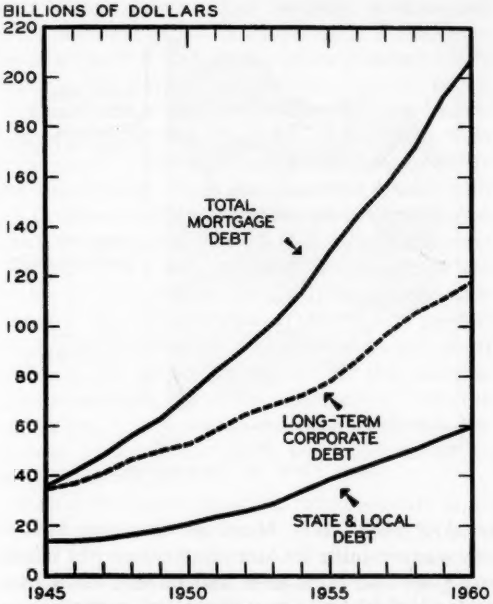
The effectiveness of these various actions is hard to judge, since they were initiated at a time when market forces were already making mortgage funds more available and at lower costs. Postwar experience is that homebuilding responds sluggishly, and only after a lag, to increasing availability of credit, but then develops an upward momentum which becomes hard to check. Thus, the record suggests moderation of measures to stimulate housing and alertness to any need for reversal.

Providing Government Credit

In addition to insurance or guaranty of private mortgage lending, the Federal Government makes available a considerable volume of housing credit by direct lending, often at low interest rates and for unusually long repayment periods. Thus, the new Housing Act provides an additional $1.2 billion in loans for college dormitory construction over the next four years; $450 million in low-interest loans for community facilities such as sewers, water works, and fire houses; $200 million additional funds for housing loans in rural areas; and $75 million for housing for the elderly. Further, the Federal National Mortgage Association was given $750 million more for purchases of existing mortgages. More than $1 billion additional loan funds were authorized in separate legislation for direct housing loans to veterans.

In all, legislation passed during the 1961 session of Congress authorized no less than $3.8 billion in government credit for the stimulation of housing. Still further amounts have been legislated as grants, including over $2 billion for urban renewal during the next four years.

This drastically enlarges the role of government in the capital market as a direct supplier of housing credit. Yet already, with encouragements from government through the FHA and VA programs, real estate mortgages have been the most voracious consumers of long-term credit in the postwar period. As the accompanying chart shows, mortgage debt and long-term corporate debt both stood close to $35 billion at the end of 1945. By 1960, long-term corporate debt had risen to $118 billion, an average increase of less than $6 billion a year, while mortgage debt had climbed to $207 billion, averaging better than $11 billion a year. The rise in state and local debt has averaged $3 billion annually over the postwar period, to help pay for schools, highways, and local improvements.



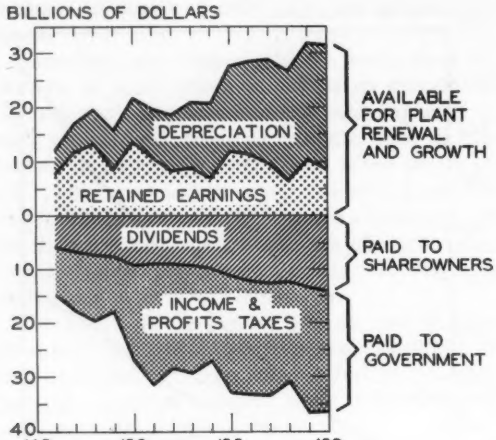
Total Mortgage Debt, Long-term Corporate Debt (Nonmortgage), and State and Local Government Debt

Thus, housing is already getting the lion's share of the supply of long-term money. This raises a question whether stimulants to housing are not tending to distort the balance of our economic growth.

There is no doubt that enlarging the supply of mortgage credit gives a boost to the construction industry and to the economy generally. But the longer-range goal of accelerating economic growth depends more upon capital formation in the form of productive facilities. Housing is investment for consumption as opposed to investment for production. If we want the economy to grow faster, there is a strong case for channeling a larger part of our savings flow into modernized equipment for American industry, both to improve our competitiveness in world markets and to supply the investment base for expanding output and jobs.

Financing Business Capital Needs

Business expenditures on plant and equipment, between $26 and $37 billion annually over the past 10 years, are officially estimated at $34½ billion for 1961. In addition, corporations need funds for working capital to pay their help and finance inventories and accounts receivable. The bulk of the needed cash is generated out of earnings and depreciation allowances. In 1960, corporate cash flow, indicated by the total shaded areas of the second chart, was in the neighbor-



Cash Flow of Corporations

hood of $68 billion. However, less than half of this was available for investment since $14 billion was paid to owners as dividends and $22 billion drained off by taxes on income and profits, shown as areas below the zero line.

Funds available for use in the business—depreciation allowances and retained earnings, shown above the zero line—amounted to $32 billion in 1960. Despite an enlarging flow of depreciation allowances—at a record $23 billion in 1960—corporations have had to rely on outside financing not only to enlarge plant facilities and provide tools for a growing labor force, but also to take advantage of new and improved techniques growing out of extensive research and development.

Expanding and modernizing business capital equipment is vital to the economic growth of the nation as well as to its ability to compete with foreign producers, who are usually able to schedule depreciation allowances on a much more liberal basis than in the United States.* The present Administration, in the tax program it proposed last April, gave recognition to the pressing need for tax relief to spur business capital investment, but the Congress has deferred action until next year and opinions differ on the exact approach to be taken. Instead of the sliding scale of investment tax credits proposed by the President, businessmen generally would prefer greater flexibility in the timing of depreciation allowances and some reduction of the present 52 per cent rate on corporate profits. This could enhance incentives and opportunities for productive investments and on a nondiscriminatory basis.

* See the article "Depreciation Allowances Here and Abroad" in the September 1960 *Letter*.

Misplaced Emphasis

Discussion of the performance of the capital market often has centered on the level and direction of interest rates. Last March, for example, Walter W. Heller, chairman of the Council of Economic Advisers, told the Joint Economic Committee that high mortgage rates had depressed the level of residential construction and that lower long-term rates were urgently needed to stimulate the economy. In April, Secretary of the Treasury Douglas Dillon declared that the Administration's purpose was to push mortgage interest rates down by one-quarter or one-half per cent below the prevailing rate. As noted earlier, the maximum FHA rate was cut, in two steps, from 5¾ per cent in February to 5¼ per cent currently.

On the other hand, reminders that actual flows of funds into investment are more important than levels of interest rates have not been lacking. In a speech last April before the Association of Reserve City Bankers, Federal Reserve Board Chairman William McChesney Martin stressed that Federal Reserve policy was aimed not at setting some particular level of rates but rather at influencing flows of funds in domestic and international channels.

This does not deny that interest rates are important. They are costs to borrowers and rewards to savers, and, as such, indicators of the balance of forces affecting the availability of capital market funds. When the availability of funds increases relative to demands, the result quite naturally is for interest rates to move down. But to assume that arbitrary reductions in interest rates would increase the availability of funds is to assume that the tail can wag the dog. In fact, an arbitrary reduction in rates can have exactly the opposite effect: the supply of funds to homebuyers, business, and government may be *reduced* as savers and investors shift their assets into other channels, including tangible property, equities, and investment outlets abroad.

Thus, if we are interested in high production and economic growth it is the volume of investment flows into particular uses which is of prime importance. Interest rate policy has a role to play in encouraging and accommodating such money flows. But to make rates the main concern is likely to be self-defeating, as the failure of cheap money policies all over the world has shown. We need to bear in mind the economic fundamentals. In Chairman Martin's words:

> In our country, the government cannot compel anyone to invest or lend his money at rates he is unwilling to accept, any more than it can compel anyone to borrow at rates he will be unwilling to pay. That is a fact that no public authority can ever afford to ignore.

The Common Market & World Trade

In August, after prolonged debate, the United Kingdom applied for full membership in the European Economic Community (EEC) or Common Market. The six founding nations of the Community welcomed Britain's move. Formal negotiations are to start this month. Several other nations that are linked with the United Kingdom in the European Free Trade Association (EFTA) are also expected to apply for full membership in the Common Market while Switzerland, Sweden, and Austria, the European neutrals, may prefer a looser association.

Britain's decision is a move of deep economic and political significance. It will promote Europe's unity and stability—an essential factor in the struggle for freedom and progress in the world. It will create the largest single market in the world, gaining substantial benefits from mass production and distribution. A rapidly expanding European market of some 300 million people will, it is hoped, lead in turn to increased demands for the products of other parts of the world and thus help expand world trade and improve the prospects for less-developed nations.

The flourishing conditions in the Common Market undoubtedly influenced Britain's decision to apply for membership. Trade within the Common Market has been greatly stimulated and is expanding much faster than trade with outsiders. Between 1957 and 1960, trade of EEC nations among themselves went up by 44 per cent while British exports to the Common Market increased by only 22 per cent. True, Britain's trade with the United States, overseas Commonwealth countries, and other nations is of greater aggregate importance; but Britain could hardly disregard the fact that, right at its doorstep, the Community was rapidly becoming the world's largest market for imported manufactures.

The Path to a Single European Market

The path to a single market for all of Free Europe is not an easy one. The Six, who have thus far been remarkably successful, will presumably wish to safeguard the essential features of the Community as presently constituted. Britain's application for membership in the Common Market is conditional on satisfactory arrangements being made to meet the interests of British agriculture, the Commonwealth, and the other EFTA members. These matters will now be probed in detail. "There are," as Britain's Prime Minister Macmillan stated, "great risks from failure and great opportunities to be gained by success."

In particular, Britain's approach to the Common Market raises a host of issues with regard to its links with the Commonwealth. For a quarter of a century, Britain has been granting lower tariffs on its imports of products such as sugar, meat, and dairy products from the West Indies, Australia, and New Zealand, and has in turn been given preferences for its exports to many Commonwealth countries. Britain's trade with the Commonwealth, even though diminishing in relative importance, nevertheless represents some two fifths of its total trade. The merging of the British market into a common European one, surrounded by common import tariffs and guided by common commercial policies, poses great problems for Britain as well as for the overseas Commonwealth countries themselves. At the same time, European agricultural producers like France, Holland, and Italy want free access to the British market.

Furthermore, the six EEC nations want to go beyond the mere freeing of trade among themselves: they seek to use free trade as an instrument of broader economic—and political—integration. Britain has traditionally preferred a less closely knit association with the Continent. Moves to "harmonize" Common Market economic, financial, and social policies are proceeding, however, slowly and cautiously. Fiscal and monetary autonomy is, in principle, unimpaired. Each member state is responsible for its balance of payments; exchange policies, though "of common interest," remain national.

Nevertheless, the Common Market nations have made remarkable advances toward complete freedom of movement of capital and labor. So far as capital is concerned, restrictions have been practically abolished in Belgium and Germany; elsewhere, they have been greatly liberalized. Britain also makes large capital investments abroad, but has retained controls over capital exports to non-sterling countries.

Ultimately, of course, the vitality and the vigor of the Common Market will depend on the ability of each member to stand up to unrestrained competition, without customs or other obstacles, in its home market. This will require economic flexibility, adaptability, and efficiency; hence the crucial importance of Britain's current efforts to safeguard financial stability and make its economy truly competitive. But if the Common Market imposes discipline, it also offers opportunity for expansion, and the two together are the main ingredients of economic success.

A New Force in World Affairs

There is thus developing in Europe a powerful group of nations. Its strength is shown by the size of its population, larger than that of the

Western Europe, the United States, and the USSR in Perspective

	EEC	EFTA	Western Europe*	United States	USSR
Area (mil. sq. miles)	0.5	0.5	1.6	3.6	7.9
Population (mil.)	169	90	328	181	214
Gross national product:					
Total (bil. $)	181	104	302†	504	n.a.
Per capita ($)	1,071	1,156	1,013†	2,785	n.a.
Steel (mil. short tons)	80	35	118	99	72
Electricity (bil. kwh.)	271	226	520	840	292
Automobile output (mil.)	3.4	1.5	4.9	6.7	0.1
Exports (bil. $)	19‡	15‡	23‡	20	6
Gold reserves (bil. $)	9.4	6.1	16.0	17.8	§

* Eighteen member nations of the Organization for European Economic Cooperation. † Excluding Spain. ‡ Excluding intra-regional trade. § Generally accepted Western estimates range from $4 to $8 billion. n.a. not available.

Sources: Organization for European Economic Cooperation and the United Nations. All data refer to 1960.

United States or Russia (although Western Europe's area is smaller). Its steel output exceeds our own as well as Russia's, and its electricity and automobile production, while second to ours, are much larger than Russia's.

It is natural that European nations be concerned with the buildup of foreign trade, for international division of labor and product specialization have contributed vitally to their prosperity. This is reflected in the large trade among the European nations themselves as well as in their commerce with the rest of the world. Even if intra-European trade is excluded, Europe is the world's largest trader: its combined shipments to overseas countries are bigger than total U.S. exports.

Europe is also the world's largest market for primary products. It is the main importer of virtually all major commodities with a few exceptions like sugar and coffee, in which the United States is the leader. By and large, what happens in Europe is now as important for the course of world trade and prices as what happens in the United States.

Spurred by the new trading arrangements as well as by remarkably effective policies to foster output and investment, many European nations have attained enviable rates of economic growth. Industrial expansion in the Common Market countries since 1955 has proceeded at an annual rate of 7 per cent, and that in Western Europe as a whole at 5 per cent, compared with 2 per cent in the United States. Up to a point, to be sure, this recent expansion represents a catching up of the large amount of ground lost during the 1930s and 1940s. But the impetus gained by diminishing commercial rivalries and the fragmentation of markets opens entirely new vistas.

Financially, Europe's strength is evident in its large gold holdings—over $16 billion, compared with some $17.5 billion in the U.S. reserve. In addition, Europe holds close to $9 billion in the form of short-term dollar claims. Once more, the leading European currencies command respect, with all the self-confidence that this implies.

It is true that Europe today is not a single economic entity. But the widening of the Common Market will strengthen the interdependence of European nations, which has always been important, and will release the dynamic forces of mass production in an environment of competition and efficiency. Wisely handled, economic unification can only be beneficial to Europe's productive power and living standards.

Trade Relationships with Outsiders

A Common Market enlarged through the accession of the United Kingdom and other EFTA countries would become an even bigger factor in world trade than the present Community. In this enlarged market, the problem of trade relationships with nonparticipating nations might thus become even more delicate than in the EEC as presently constituted. Removing trade restrictions within a closed area helps insiders but puts outsiders at a disadvantage. Most countries outside Europe are naturally concerned with the growth of new tariff discriminations that may hurt their markets in Europe—for agricultural products, raw materials, and manufactures.

So far, internal tariffs of Common Market countries have been cut 30 per cent below the 1957 level; another 10-20 per cent decrease, presently under consideration, would reduce tariffs by as much as 50 per cent only four years after the Common Market was established. Import quotas among members on industrial goods are to be eliminated by the end of this year. Within the EFTA group, the first tariff reduction of 20 per cent was carried out in July 1960 and an additional one of 10 per cent in July 1961, six months ahead of schedule. The dismantling of trade barriers has thus kept pace within each of the two groupings. The Common Market nations made the first adjustments in their tariffs against the rest of the world in January 1961, a year ahead of schedule.

It is encouraging that a good part of last year's tariff reductions among the six founding Common Market nations was "generalized" to outside countries, including the United States. Furthermore, during this year's round of tariff discussions under the General Agreement on Tariffs and Trade (GATT), the Common Market nations offered a 20 per cent across-the-board cut in the Community's industrial tariffs against nonmembers; full reciprocity would not apparently be required from the United States, which had made more than its share of tariff reductions in

the years following the war. For instance, rates on automobiles are 8.5 per cent in the United States but 27-29 per cent in the Common Market external tariff as presently scheduled; the rate is 30 per cent in the United Kingdom.

The problem of trade barriers in the agricultural field is particularly difficult, owing to the need for developing a common agricultural policy in the Community. Not only the United States but Latin America, the Commonwealth countries, and other outsiders have a vital stake in the treatment of agricultural imports by Europe.

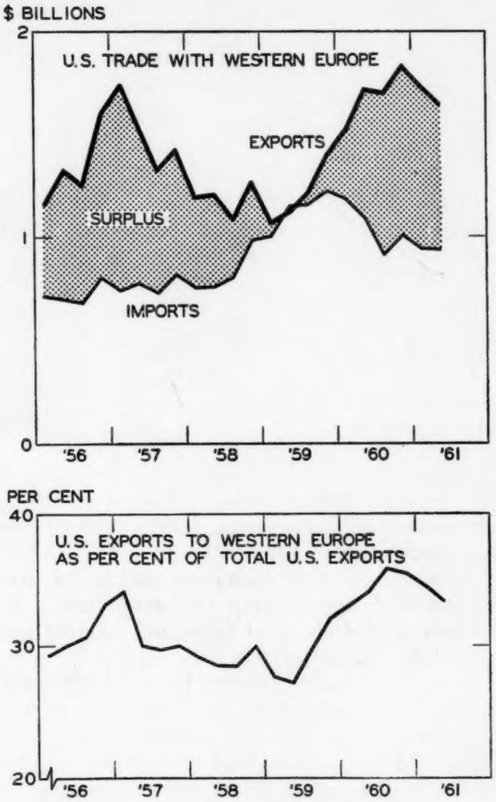
In the enlarged Common Market, much would obviously depend on the level of the common tariff against outsiders and the manner in which it would conduct its external commercial policy in general. The common tariff would have to be consistent with GATT, which requires that it should be no more restrictive than the individual rates prior to the establishment of a new customs union.

Like other outside countries, the United States is vitally interested in Europe's regional trading arrangements. Western Europe is our largest trading partner, and over the years has accounted for an increasing portion of our foreign commerce. Currently, our trade with Europe accounts for one third of our exports and more than one half of our total trade surplus; U.S. exports to Europe exceeded imports from that area by $3 billion during the twelve months ended June 1961. Our trade surplus with Europe helps reduce our large payments deficits with Europe on account of services, defense outlays, and capital investment.

The substantial expansion in our exports to Europe—at least until a few months ago—shows that increased demand for American goods can offset the adverse effects of tariff changes. In the long run, it must be hoped, the expanded market now being created in Europe, joined with liberal trade policies vis-a-vis outsiders, will materially enlarge outlets for U.S. exports just as our economic growth, and liberal import policies, have enlarged European opportunities in this market.

Wider Implications

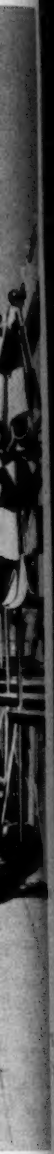
Elsewhere in the world, groupings similar to the Common Market are also emerging. Last June, a Latin American Free Trade Association, formed by seven nations, was set in operation. A Central American Common Market comprising four countries has been in existence for a year. Regional Asian and African groupings are being discussed. Ripples from the economic tidal wave set in motion by the signing in 1957 of the Treaty of Rome, which created the EEC, have thus spread throughout the world.



U.S. Merchandise Trade With Western Europe
Quarterly
(Excluding exports under military aid programs)

These moves, particularly on the part of less-developed nations, stem from an understandable desire to speed up industrialization. But they also reflect the desire to strengthen their bargaining position vis-a-vis the European Common Market. The EEC places fairly high tariffs on tropical products like coffee, cocoa, and tea produced by nonparticipating nations while allowing similar imports from members' "associated territories" overseas to be free of duty.

The emergence of these regional groupings constitutes a major challenge for Free World economic statesmanship. Above all, it is necessary to avoid the dangers of splitting the world into three or four blocs. For this, it is essential that the regional groupings look outward, not inward, and build up their own strength while ready to help others. This would fortify the fabric of global, in contrast to regional, trade and increase the economic and political cohesion of the Free World.



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